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Global equity markets rallied during the final quarter of 2011 as the U.S. averted a "double-dip" recession and European debt crisis fears subsided. Despite the global macro-economic uncertainty, U.S. economic activity continues to show signs of improvement and we think that on a longer term basis, there are attractive investment opportunities in the markets today.

Looking back, 2011 was a year of surprises. The continued decline in U.S. interest rates and strength of the U.S. dollar, the geo-political and social unrest that spread around the world and the widespread impact of the European debt crisis were notable events that had a significant impact on global markets.

Although U.S. markets faced multiple headwinds in 2011, the S&P 500 was one of the top performing indices for the year and dramatically outperformed other prominent global indices. The S&P 500, including dividends, appreciated 2.11% in 2011, compared to the MSCI all world index – ex U.S. which declined 13.01%. The French CAC declined 13.45%, the German DAX declined 14.69% and the Chinese Shanghai index declined 25.76%.

Global Macro Developments Influence U.S. Markets

Market volatility remained high during the fourth quarter with global equity markets reacting to the latest news or rumor to circulate regarding macro-economic developments. We have not experienced this much day to day market volatility since the fourth quarter of 2008, when the S&P 500 declined 23% over the sixty five trading days during the quarter.

Debt crisis contagion fears spread from Greece to Spain and Italy in November. In context, Italy is the third largest bond market in the world with annual funding needs of 350 billion euros; which is equal to Greece's entire outstanding debt. Ultimately, Italian Prime Minister Silvio Berlusconi was forced to resign as he was unable to implement the necessary austerity measures that were required to bolster market confidence. Although European bond yields have eased, they remain elevated as investors question the region's ability to come to a definitive resolution. European nations will continue to face challenging economic conditions as the region works through the sovereign debt crisis in 2012 and beyond.

Over the past decade, expansion of U.S. corporations into emerging market economies has provided significant growth drivers to revenues and earnings growth. Recently these countries have come under pressure as economic growth has begun to decelerate. Chinese growth slowed as the country battled rising inflation, India reported economic growth below 7.0% for the first time since 2009, while Brazil reported annualized growth last quarter of just 2.1% down from 6.9% in the year ago time frame. Several countries including China and Brazil have taken initial steps to loosen both monetary and fiscal policy in an effort to accelerate economic growth. However, questions still remain, in particular with China, given that Europe accounts for over twenty percent of China's total exports. If growth in China significantly slows the global economy will be negatively impacted.

Outlook for 2012

As we enter 2012, we remain encouraged regarding the outlook for U.S. equity markets as economic data has continued to improve since the end of the summer. Consumer confidence and manufacturing activity both rebounded last quarter. The unemployment rate has started to decline and weekly jobless claims are trending at their lowest level since 2008.

Overall, the long-term backdrop for equity investments remains positive. Corporate balance sheets are the healthiest they have been in decades and profit margins continue to expand as companies streamline their organizations. At the same time, dividend yields continue to exceed bond yields and equity valuations are at near record lows.

Today, we see interest rates remaining low well into 2013 as the Federal Reserve continues to promote measures to stimulate economic growth. Although inflation expectations have dampened, we continue to be concerned about the impact from the rapid expansion of the global monetary base.

Despite gold's dramatic appreciation over the past decade, the commodity could come under near-term pressure as the investor base continues to evolve. Some investors have been utilizing gold as a hedge against central banks printing money, while other investors view gold as a safe haven during times of global uncertainty. Gold's attractiveness across the var-

Figure 1: Significant Market Movement Days during the 4th Quarter of Each Calendar Year

	2006	2007	2008	2009	2010	2011
+/- 1.00%	3	24	51	22	11	37
+/- 2.00%	0	5	40	4	2	16
+/- 3.00%	0	0	30	0	0	4

Source: Bloomberg, Inverness Counsel, LLC

ious investor types could diminish if markets begin to stabilize, eliminating the need for additional quantitative easing.

The deleveraging process will continue in 2012 as governments, companies, and consumers improve their respective balance sheets. Despite the low interest rate environment, the availability of credit remains tight as lending standards have become more restrictive. Ultimately, we think the consumer deleveraging process will take longer than expected and will weigh on economic growth.

All Eyes Turn to Washington

We could see a significant shift in the world's political leadership starting in 2012. Elections and changes are planned in China, Russia, France and the U.S next year. These four countries account for close to 40% of global GDP. In total, twenty-four nations, including Spain, India and Mexico will hold elections in 2012, representing over 50% of the world's GDP.

As the year progresses, the U.S. presidential election will garner increasing attention from the media and global equity markets. The political stalemate in Washington will no doubt continue. On the campaign trail, we hope candidates focus on promoting programs designed to revitalize American growth and encourage global leadership, rather than rhetoric that further polarizes the country.

Historically, over the past eighty years presidential election years have delivered strong equity market returns. Stocks have averaged a 14.5% return when a Democrat incumbent president is re-elected, and 18.8% when a Republican is newly elected. However, historical trends do not always hold true as we have experienced negative equity returns in two (2000 and 2008) of the last three presidential election years.

Course of Action

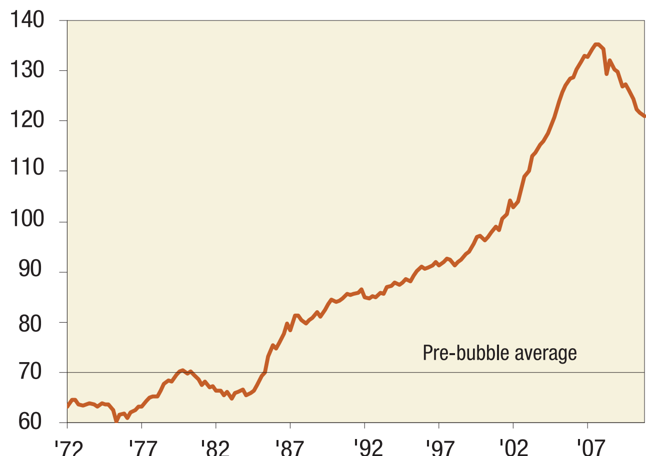
We continued to put cash to work during the quarter taking advantage of the increased market volatility. In the near-term, our focus remains on identifying companies that are able to execute in this challenging business environment. As a result, we selectively added to positions within the Energy, Industrial, and Technology sectors. We believe these companies are category leaders that were unjustifiably punished during the recent market decline.

We remain underweight the Financial sector as we think the consumer deleveraging process coupled with the Federal Reserve's latest tactic "Operation Twist" will put added pressure on banks' earnings power. In addition, financial institutions will likely face pressure in 2012 as presidential candidates debate new regulations.

On a longer term basis, we seek to invest in companies that are positioned to capitalize on the development of new market opportunities, companies that can consistently monetize their competitive advantage, companies that proactively deploy capital, and companies with strong cash flow and low debt levels that can withstand periods of deleveraging. Ultimately, we strive to identify investment opportunities where we think the intrinsic value exceeds the current price.

Figure 2: The U.S. Consumer Deleveraging Process Has Just Begun

Source: Federal Reserve Board



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